



Run-up to Budget 2006-07

It is budget time once again and we take this opportunity to present our pre-budget report. The last budget by the finance minister (FM) Mr P Chidambaram went into the history books as the budget for "Aam Aadmi" characterised by the enhancement of the basic exemption limit for income tax and also for "India Inc" by the reduction of the corporate income tax rate from 35% to 30%.

The good news—fiscal deficit target likely to be met...

After the last budget, many felt that it would be difficult for the finance minister to achieve his fiscal deficit target; however, the data for April-December 2005 indicates that the government has performed extremely well both on the revenue front as well as in controlling expenditure. We are thus confident that the fiscal deficit target for FY2006 will be met.

...and no major changes in direct tax rates

The FM has already stated that there will be no significant changes in the direct tax rates. Thus no major expectations are built up on the direct tax front from the budget. However the FM is expected to lower the peak customs duty and extend the ambit of the value added tax (VAT) and the service tax in the current budget.

...while cars could get cheaper

In the budget 2005-06, the FM had reduced the peak excise duty rate from 24% to 16% for three of the total five items. The two items, which were left with the 24% duty rate, were aerated drinks and motor cars. In his budget speech

Likely winners of budget 2006-07

Automobiles:	Maruti Udyog, Mahindra & Mahindra, Tata Motors.
Banking:	HDFC Bank, ICICI Bank, SBI.
Insurance:	Aditya Birla Nuvo, Bajaj Auto, HDFC, ICICI Bank.
IT Hardware:	D-Link, HCL Info Systems, MRO-Tek, Zenith Computers.
Oil & Gas:	BPCL, HPCL and IOC.
Pharma:	Alembic, Ajanta Pharma, JB Chemicals, Zandu Pharma.
Power:	NTPC, Reliance Energy, Tata Power.
Textiles:	Banswara Syntex, Rajasthan Spinning, Sangam India.
Telecom:	Aditya Birla Nuvo, Bharti Tele Ventures.

Likely losers of budget 2006-07

Oil & Gas:	Reliance, ONGC.
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Will the market go up post-budget?

Historical evidence suggests that the market normally rallies pre-budget (4 times in the past 6 years) and falls post-budget (in each of the last 6 years). Could this time be different? We think there would be three key factors which would determine the post-budget direction of the market.

1. Will the government be able to manage the fiscal deficit in FY2007? The government needs to make its first budgetary allocation for the Rural Employment Guarantee Scheme, which according to some estimates could cost around Rs35,000 crore. If the government is able to club/rationalise the other social sector schemes and control expenditure while raising revenue (from the service tax and the non-tax revenue such as PSU dividends and divestment of non-navaratnas) and thus project a credible fiscal deficit for next year, it would be a huge positive for the market and would ease the concerns on the interest rates and government borrowing.
2. The implementation of the Lahiri committee report. This would be a huge positive, as it would make FII investments easier and increase India's weightage in the MSCI benchmark index by up to 30%.
3. Any indications of continuing with/increasing the pace of economic reforms would also lead to a re-rating of the market. Most market participants are currently not factoring in an increase in the momentum of economic reforms given the upcoming elections in West Bengal and Kerala and the reported strain in the relations between the Left Front and the ruling UPA coalition.

last year, the FM had said, "manufacturers of motor cars and aerated drinks, the other two items will have to wait for some more time." It is widely expected that the waiting period for the manufacturers of motor cars will be over this time.

In the forthcoming budget, apart from the thrust on the rural economy in the form of continued reforms for the agriculture sector, it is expected that the automobile, textile, food processing and the leather and leather products industries will get special attention as these industries have a great potential to generate employment.

Fiscal performance YTD	Rs '000 crore			
	Apr - Dec	YoY	FY06B	Ytd of B
a. Revenue receipts	216.7	15.0	351.2	61.7%
Net tax revenues	168.7	19.4	273.5	61.7%
Non - tax	48.0	1.7	77.7	61.8%
b. Non debt receipts	7.4	(84.6)	12.0	61.8%
c. Total receipts (a + b)	224.2	(5.2)	363.2	61.7%
d. Revenue expenditure	296.4	17.9	446.5	66.4%
e. Capital expenditure	36.1	(52.1)	67.8	53.2%
f. Total expenditure (d + e)	332.5	1.7	514.3	64.6%
g. Fiscal deficit (f - c)	108.3	20.1	151.1	71.7%
h. Revenue deficit (d - a)	79.7	26.5	95.3	83.6%

Source: Controller General of Accounts: Budget Documents

Key budget expectations—taxation

- ♦ Reduction in the peak customs duty rate by 2-3% from the current rate of 15%.
- ♦ Getting sugar, textiles and tobacco under the net of the VAT.
- ♦ Reduction of the central sales tax (CST) from the current level of 4% to 2%.
- ♦ Simplification of the fringe benefit tax (FBT) structure by lowering the base for the valuation of the expenses or to completely wipe off the FBT on certain expenditure categories.
- ♦ Adding new services under the ambit of the service tax.
- ♦ Excise and customs duty cuts for the automobile and the synthetic textile segments.

Other policy initiatives

- ♦ Increase in insurance FDI to 49%.
- ♦ Continued thrust on agriculture with more spending on irrigation and water storage.
- ♦ Investment sops for the food processing and leather and leather products sectors to generate more employment.
- ♦ Extending the VAT rollout through tax compensation and the CST phase-out.

Capital market related initiatives

- ♦ Imposing security transaction tax (STT) on off market deals.
- ♦ Allowing the mutual funds to set off the gains from the derivatives against the general losses suffered during the year.
- ♦ As per the recommendations of the Lahiri committee, increasing the FII investment limit to over and above the sectoral foreign direct investment (FDI) caps.

Sector-specific impact

Automobiles

Issue	Current status	Likely changes	Impact
Excise duty	24% on passenger cars and utility vehicles	Reduced to 16%	Positive for the sector. Companies to benefit Maruti, M&M, Tata Motors.
National calamity contingent duty	1% on motor vehicles	To be removed	Positive for the sector. Companies to benefit Maruti, M&M, Tata Motors, Bajaj Auto, Hero Honda.

Banking

Issue	Current status	Likely changes	Impact
Preference share capital	Banks are not allowed to issue preference shares under the Banking Regulation Act, 1949	Allowing the issue of preference shares and its inclusion in tier-I capital	Positive for the sector and especially for state-owned banks. Companies to benefit SBI, Union Bank, Corporation Bank, Canara Bank.
Exemption for savings deposit u/s 80	Currently not part of investments u/s 80	Inclusion of savings bank deposits for tax exemption u/s 80	Positive for the sector. Companies to benefit ICICI Bank, UTI Bank, SBI, Union Bank, Corporation Bank.

Cement

Issue	Current status	Likely changes	Impact
Customs duty	Custom duty on coal is 5%	Reduction to 0%	Positive for companies that procure imported coal like Gujarat Ambuja, UltraTech Cement.
VAT	Implementation of the VAT in selective states	Extended VAT to all states	Positive for companies like Shree Cements, Jaiprakash, Gujarat Ambuja Cement, Madras Cements, India Cements.

Engineering and capital goods

Issue	Current status	Likely changes	Impact
Customs duty	Currently 15%	Reduce to 10%	Negative for the sector, as imported capital goods likely to become cheaper. Companies that could be marginally affected are Kirloskar Bros, KSB Pumps, SKF India, Crompton, Thermax etc. However, the same could be offset by higher infrastructure and rural spending.

Ferrous metals

Issue	Current status	Likely changes	Impact
Excise duty	16% on construction grade steel	Reduce to 8%	Positive for the sector. Companies to benefit Tata Steel, SAIL, Jindal Steel.

FMCG

Issue	Current status	Likely changes	Impact
Excise duty	Abatement on soap at 35%	Increase to 40%	Negative for soap manufacturers located in excise heavens—as the price differential narrows. Companies that will be hurt include Godrej Consumer.
VAT Additional excise duty	Tobacco products exempt 10% on tobacco products	4% VAT to be introduced Scrapped	Positive impact of the scrapping of the 10% AED to be negated by the 4% VAT imposed. Marginal impact on ITC.
CST	4% currently	Reduce to 2%	Positive for the sector. Companies to benefit Godrej Consumer, Hindustan Lever, Proctor & Gamble.
Income tax	FBT on advertising	Simplification of rules	Positive for the sector. Companies to benefit Godrej Consumer, Hindustan Lever, Proctor & Gamble.

IT services

Issue	Current status	Likely changes	Impact
Income tax	Exemptions 10A/10B FBT	Exemptions to continue Simplification of rules	No impact. Positive for the sector. Companies to benefit Infosys, Satyam, Wipro.

IT/Telecom hardware

Issue	Current status	Likely changes	Impact
Excise duty	16% on telecom and broadband access equipment	Reduce to 12% or 8%	Positive for the PC manufacturers like HCL Infosystems, Zenith Computers and consumer premise equipment makers like D-Link and MRO-TEK.
Income tax	Depreciation on personal computers and consumer premise equipment, like routers and modems	100% depreciation	Positive for the PC manufacturers like HCL Infosystems, Zenith Computers and consumer premise equipment makers like D-Link and MRO-TEK.
Entertainment tax	30% for services provided through the broadband platform	To be waived off	Positive for hardware manufacturers on account of higher demand. Companies to benefit MRO Tek, D Link.

Oil & gas

Issue	Current status	Likely changes	Impact
Excise duty	Rs13 per litre on petrol	Reduction	Positive for marketing companies like HPCL, BPCL and IOC.
	Rs3.25 per litre on diesel	Reduction	
	8% ad valorem duty on petrol and diesel	Reduction	Positive for marketing companies like HPCL, BPCL and IOC.
Customs duty	5% on crude oil	To be removed	Positive for oil refiners like Bongaigaon Refinery, Kochi Refineries, Chennai Petroleum. Negative for ONGC.
	10% on petroleum products	To be reduced	Positive for marketing companies like HPCL, BPCL and IOC. Negative for oil refiners like Bongaigaon Refinery , Kochi Refineries, Chennai Petroleum.

Pharma

Issue	Current status	Likely changes	Impact
Excise duty	Currently 16%	Reduce to 8%	Positive for mid and small sized companies like Alembic, JB Chemicals, Ajanta Pharma, Zandu Pharma. Negative for Cipla, Unichem Laboratories, which have plants in excise free areas.
Trade margins	Non-regulated	Expected to be regulated	Negative impact on the generic drug wholesalers and retailers.
Health cess	Not present	2% on all central taxes	Positive for the sector due to increased spending on healthcare. Companies to benefit Ranbaxy, Cipla, Wockhardt, Lupin, GSK Pharma.

Power

Issue	Current status	Likely changes	Impact
Customs duty	10% on Naphtha and gas	Reduce to 5%	Positive for generation companies like NTPC, Reliance Energy, Tata Power.
	5% on thermal coal	Reduce to zero	Positive for generation companies like NTPC, Reliance Energy, Tata Power.
Income tax	80IA benefit of income tax not applicable	Extend the benefit to power till 2012	Positive for generation companies like NTPC, Reliance Energy, Tata Power.
Ultra mega power project (UMPP)	No incentives	Duty waiver for generation equipments deployed in UMPP	Positive for NTPC.

Telecom

Issue	Current status	Likely changes	Impact
Revenue share	10% for category A and 8% for category B circles	Reduce to 6%	Positive for the telecom service providers. Companies to benefit Bharti, MTNL, Tata Teleservices.
	Asset (mobile handsets as a part of bundles offer) sale revenues are shared	Not to be shared	Positive for the telecom service providers. Companies to benefit Bharti, MTNL, Tata Teleservices.

Textiles

Issue	Current status	Likely changes	Impact
Excise	Excise duty on man made fibre - polyester, viscose and acrylic - 16%	Reduce to 8%	Positive for companies in the synthetic spun yarn segment. Companies to benefit Banswara Syntex, Rajasthan Spinning, Sangam India.
	Excise duty on textile machinery - 16%	Reduce to 8%	Positive for the sector. Companies to benefit Alok Industries, Welspun India, Nahar Industries.
Customs	Customs duty on PTA, DMT and MEG - 15%	Reduce to 10%	Positive for companies in the synthetic yarn segment. Companies to benefit Banswara Syntex, Rajasthan Spinning, Sangam India. Negative for Reliance.
	Custom duty on MMF - 15%	Reduce to 10%	
	Custom duty on textile machinery - 15%	Reduce to 10%	Positive for the sector. Companies to benefit Alok Industries, Welspun India, Nahar Industries. Negative for Lakshmi Machine Works with increased imports of machinery.
VAT	4% VAT implemented in certain states	To be implemented in all the states	Negative for the players catering to the domestic industry. Companies like S Kumars Nationwide.

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